# Corporate Governance, Firm Financial Performance and Shareholders' Confidence: A Proposed Analysis of MCCG 2012

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**Abstract**

**Purpose:** It is a common belief that an independent board improves firm financial performance and shareholders' confidence. The separate leadership structure and independent chair of the board are considered to strengthen independence of the board. This paper, therefore, proposes to investigate that how Malaysian Code on Corporate Governance (MCCG 2012) impacted board independence (separate leadership structure and independent chair) and its relation with firm performance and shareholders' confidence.

**Design/Methodology/Approach:** The proposed model of the paper based on agency theory and MCCG 2012, recommends to investigate that how MCCG 2012 impacted shareholders' confidence with a mediation of firm performance in pre and post context of the code from 2010-2013. The proposed data regarding corporate governance will be collected from annual reports while firm financial performance (ROE & EPS) and shareholders' confidence (share price) from DATA STREAM for a sample of 300 Malaysian listed companies.

**Findings:** The MCCG 2012 anticipated that independence of the board will improve firm performance and shareholders' confidence. However, these anticipations yet lack empirical support. Thus, this paper proposes to find empirical evidence and fills the literature gap.

**Practical Implications:** The proposed study will provide empirical evidence that how the code (separate leadership structure and independent chairman) impacted its level of compliance, firm performance and shareholders' confidence which will have value for Bursa Malaysia, Securities Commission, shareholders and management of the companies in Malaysia.

**Originality/Value:** The limited literature regarding CG codes in pre and post context has been investigated in relation to firm performance. This paper proposes to investigate the mediation role of firm performance between MCCG 2012 and shareholders' confidence which has never been investigated earlier. Moreover, the proposed study will be the first study related to MCCG 2012 as the previous literature is regarding other codes in Malaysia or outside.

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**Paper Type:** Literature Review

## Introduction

It is a common belief that corporate governance (CG) improves firms' financial performance (Attia, 2012; Young, 2003) which boost up shareholders' confidence as shareholders are more interested in firms' profitability (Khanna & Zyla, 2010). CG improves firm performance which enhance shareholders' confidence as evidenced by quick response of the stock market (Gompers et al., 2003). Weak implementation or compliance of CG practices leads to firms' poor financial performance, which ultimately cause corporate failure (Sanjai Bhagat & Black, 2001; Sanjay Bhagat & Bolton, 2009; Norwani, Mohamad, & Chek, 2011). Firms' poor financial performance leads to corporate failures which weaken shareholders' confidence as they suffer the most (Khanna & Zyla, 2010; Norwani et al., 2011).The goal of CG regulations is to improve firm governance and performance. Thus, the implementation and compliance of strong CG regulations enhance shareholders' confidence (Bhagat & Bolton, 2009; Lama, 2013; Shleifer & Vishny, 1997). Shareholders hesitate to provide their money to corporations on mere assurance of the managers that they will get their money back. They require a strong assurance in the shape of regulatory protection which can ensure the safe return of their money along with return (Klapper & Love, 2004; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000). The regulatory theory postulates that regulations improves firms' conformance and performance which enhance shareholders' confidence (Sanjay Bhagat & Bolton, 2009; La Porta et al., 2000; Lama, 2013). Therefore, many countries introduced CG legislations, regulations and codes to improve firms' financial performance and enhance shareholders' confidence (Abdullah, 2004; OECD, 2011; Petra, 2005). Malaysia also recently introduced its new CG code MCCG 2012 in March, 2012 with anticipation of improving firms' financial performance and boosting up shareholders' confidence. The code among others, mainly addressed independence of the board, as agency theory suggests that an independent board protects shareholders' interests by ensuring effective monitoring of managers' performance (Fama & Jensen, 1983). The effective monitoring role of board improves firms' financial performance and minimizes chances of corporate failures which enhance shareholders' confidence. The shareholders of developing and emerging markets consider CG as a mechanism of profit maximization hence firms' better financial performance enhances their confidence (Khanna & Zyla, 2010). Though shareholders' primacy, regulatory and agency theories support anticipations of the code, but it is also argued that Government or regulatory intervention for improving firms' performance is an open debate with mixed arguments (Vafeas & Theodorou, 1998; Hussin and Othman, 2012).Thus, this paper proposes to investigate the impact of separate leadership structure and independent non-executive chairman of the board as recommendations of MCCG 2012 on shareholders' confidence with a mediating effect of firm financial performance from 2010 to 2013 in pre and post context of the code. The comparison of 2 year pre and 2 year post enactment periods of the code will highlight its impact on the level of compliance on the practices of separate leadership and independent chair of the board. Moreover, it will also explain that how these two practices impacted firm performance and shareholders confidence in Malaysia.The proposed study will test the assumptions of regulatory, agency and shareholders' primacy theories in Malaysian context. It will contribute to the literature as the limited literature regarding CG codes in pre and post context has been previously examined its relation mostly with firm performance (Owusu, Weir, & McLaverty, 2012). Whilst, this paper proposes to investigate the relationship between MCCG 2012 and shareholders' confidence with a mediating effect of firm financial performance in pre and post context of the code, which has never been investigated earlier. Moreover, previous studies are regarding other CG codes in Malaysia or outside while this proposed study is regarding MCCG 2012 which has never been examined.

## Literature Review

The literature evidenced investigations regarding CG and firms' performance with mixed and inconclusive empirical findings (Ponnu, 2008). For example, some studies showing that CG has no relation with firms' performance (Karpagam, 2013). In contrast, many studies concluded that CG has a positive impact on firms' financial performance (AlMutairi, 2008; Kyereboah-Coleman, 2007; Rahman, Ibrahim, & Zahid, 2014; Shukeri, Shin, & Shaari, 2012; Tham, Marn, & Romuald, 2012). It has been documented that the implementation and compliance of CG practices improve firms' financial performance (Klapper & Love, 2004; Noor & Fadzil, 2013; Nur'ainy, Nurcahyo, Kurniasih, & Sugiharti, 2013; Velnampy, 2013) and their weak implementation or compliance leads to firms' poor performance. Firms' poor financial performance causes corporate failures which ultimately traumatize shareholders' confidence as they suffer the most. Hence, the scandals of Perwaja Steel, Technology, Resources Industries (TRI), Transmile Air Services Sdn. Bhd., Megan Media Holdings Bhd, Malaysian Airlines System (MAS) and Port Klang Free Zone detroirated shareholders' confidence in Malaysia (Nur'ainy et al., 2013). The financial scandals of Linear Corporation (2008), Kenmark Industrial Co. Ltd. (2010), and Sime Darby (Sime) (2010) further weakened shareholders' confidence in Malaysia (Hamid & Aziz, 2012; Hussin and Othman, 2012). In addition, the Global Financial Crisis 2007-08 also seriously damaged the trust and confidence of shareholders in Malaysia like other countries of the world (OECD, 2011). Bursa Malaysia index dropped by 670 points which was the biggest decline in the country after Asian Financial Crises 1997-98 (Angabini & Wasiuzzaman, 2011). Subsequentley,the Securities Commission Malaysia issued a new CG code MCCG 2012 in March, 2012 to improve firms' financial performance and shareholders' confidence.

Malaysia introduced first CG code (MCCG 2000) in 2000 to boost shareholders confidence after Asian financial crises in 1997-98 (Abdullah, 2004). After different developments in domestic and international markets, Malaysia revised MCCG 2000 (Revised MCCG 2007) in 2007 which superseded the previous code. The previous studies examined that how previous two CG codes (MCCG 2000 & 2007) impacted firms' financial performance before and after the enactment of these codes in Malaysia (Hamid & Aziz, 2012; Noor & Fadzil, 2013). However, these studies are limited to investigating the impact of CG codes on firms' financial performance and not extended to investigate shareholders' confidence. The results of these previous studies are also mixed and inconclusive (Hamid & Aziz, 2012; Noor & Fadzil, 2013). For example, a study investigated the impact of MCCG 2000 on firms' financial performance and reported that there was no relation between CG and firms' financial performance before the implementation of the code. However, the relationship was positive after enactment of the code (Saad, 2010). Similarly, the impact of the board independence, expertise of the board and audit committee as practices of MCCG 2007 was analyzed on financial performance of Govt. Linked Companies (GLCs) in pre and post context of the code. The results only supported the expertise of audit committee in positive relationship with the financial performance of GLCs after the enactment of the code (Hamid & Aziz, 2012). A study investigated the impact of MCCG 2007 on firms' financial performance for 2 years i.e. 2006 and 2008. The 2 year period of the study represented one year pre and one year post context of the code. The results stamped significant positive impact of boards' characteristics on firms' financial performance in the post enactment period of the code (Noor & Fadzil, 2013). Another evaluation of the relationship between MCCG 2007 and firms' financial performance before and after enactment of the code found that board and audit committee both have significant positive impact on firms' financial performance after enactment of the code (Noor & Fadzil, 2011). In contrast a study found that the practice of MCCG 2007- board of directors and audit committee in relation to firms' financial performance provide weak evidence to support that firm practicing good CG perform well as compared to those which don't. The study doesn't support the enactment of MCCG 2007 (Hussin and Othman, 2012).

The literature showing pre and post analysis of MCCG 2000 and MCCG 2007 clearly necessitates a study in a similar context for the new code MCCG 2012. Moreover, the previous literature is limited to CG codes and firms' financial performance, ignoring shareholders' confidence – survival of the companies. Thus, this paper proposes to investigate how specific practices of MCCG 2012 (separate leadership structure and independent non-executive chairman) impacted shareholders' confidence with a mediating effect of firms' financial performance in pre and post context of the code from 2010 to 2013 to fill the exhibited gap in literature.

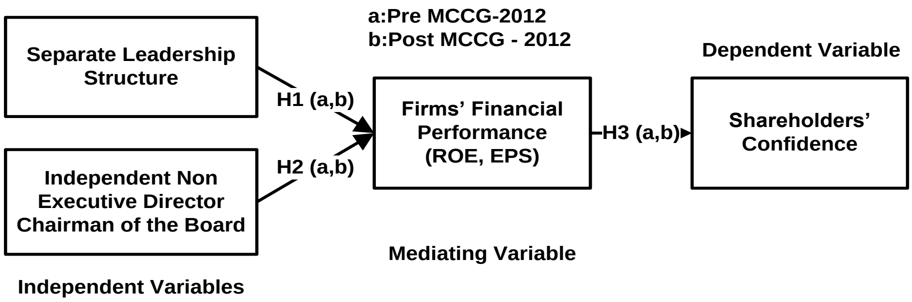


Figure 1: Proposed Conceptual Framework

*Separate Leadership Structure and Firms' financial Performance*

The separation of CEO and COB (Chairman of the board) is called separate leadership structure (Petra, 2005). The Agency theory postulates the separation of CEO and COB on account of effective monitoring of the managers' performance (Fama & Jensen, 1983). The recommendation # 3.4 of MCCG 2012 describes as:

"The positions of chairman and CEO should be held by different individuals and the chairman must be a non- executive member of the board."

The separation of two roles of CEO and Chairman of the Board (COB) is supported by agency theory that it improves firms' financial performance (Sanjai Bhagat & Bolton, 2008; Tham et al., 2012). Yusoff & Alhaji, (2012) empirically endorsed this by documenting that duality has negative impact on firms' financial performance. In contrast, stewardship theory suggests combination of the two roles of CEO and COB for firms' better performance (Donaldson & Davis, 1991). In addition, the theory postulates that executives are stewards of the firm who protect shareholders' interests and maximize their wealth. The stewardship theory based on social psychology, proposes that managers' are committed towards firms' success (Davis, Schoorman, & Donaldson, 1997). Shukeri et al., (2012) argued that duality of CEO doesn't impact firms' performance negatively. Apart from these positive and negative theoritical postulations and empirical evidences, Ponnu, (2008) deny any link between duality and firm performance. He argued that duality of CEO has no significant relation with firm financial performance.Thus, empirical results of the relationship of separate leadership structure with firms' financial performance are mixed and inconclusive; hence needs to be further investigated specifically after the introduction of MCCG 2012. This paper, therefore, proposes further examination of the relationship from 2010-2013 in equal intervals of 2 periods representing 2 years before and 2 years after enactment of the code. The hypothesis of the proposed study on the basis of agency theory are:

*H1 (a): Separate leadership structure is positively correlated to firms' financial performance before MCCG 2012.*

*H1 (b): Separate leadership structure is positively correlated to firms' financial performance after MCCG 2012.*

*Independent Non-Executive Director Chairman of the board and Firms' financial Performance:*

Board has a key role in disciplining management and ensuring internal governance of the firms (Fama, 1980). However, only an independent board can better perform this role. Independent non-executive chairman strengthen board's independence which improve firms' financial performance (Fama & Jensen, 1983). In absence of an independent outside director chairman the potential conflict between management and shareholders becomes more severe and complicated (Coles & Hesterly, 2000). The presence of an independent non-executive chairman becomes more important if the CEO is powerful and influential (Balsam, Puthenpurackal, & Upadhyay, 2011). Independent non-executive chairman is comparatively more free from the influence of management, which improve firms' financial performance by ensuring better monitoring role of the board (Balsam et al., 2011). The recommendation # 3.4 of MCCG 2012 explains that:

"The positions of chairman and CEO should be held by different individuals and the chairman must be a non-executive member of the board".

The non executive chair of the board was proposed by Securities Commission (SC) in the CG blue print document. It included in the code after one month public response since proposed in July 2011. The empirical findings evidenced that outside chairman helps ensure effective monitoring of the board which improves firms' financial performance (Hussin and Othman, 2012). An increasing trend of appointing independent non-executive chairman has been found in the USA as they are considered to improve firms' financial performance (Balsam et al., 2011). The announcement of independent chairman of the board is positively responded by shareholders (Balsam et al., 2011; Coles & Hesterly, 2000). On contrary, it is argued that independent non-executive chair of the board is costly (Coles & Hesterly, 2000). Moreover, the chair has low value in technical and complex corporations (Balsam et al., 2011). The inconclusive and mixed results of the limited literature regarding the impact of independent non-executive chairman on firms' financial performance highlight the need for further investigation of the relationship. This investigation becomes more important after the introduction of MCCG 2012. Hence, this paper proposes to further investigate the impact of independent non-executive chairman on firms' financial performance from 2010 to 2013. On the basis of agency theory following are hypothesis of the proposed study.

*H2 (a): The independent non-executive director chairman of the board (Independent leadership) is positively*
*correlated to firms' financial performance before MCCG 2012.*
*H2 (b): The independent non-executive director chairman of the board (Independent leadership) is positively .*
*correlated to firms' financial performance after MCCG 2012.*

*Firms' Financial Performance and shareholders' confidence*
After legislations and regulations, firm financial performance is the second key driver that determines shareholders' confidence (Dailami & Masson, 2009). Financial performance not only explains the current but also predict firms' future financial health (Menike & Prabath, 2014).The shareholders expect higher return on their investments. Thus, an increase in share price enhances shareholders' confidence (Benali, 2013; Placido M. Menaje, 2012). The shareholders' confidence is enhanced if firm maximize their wealth (Dobson, 1999 ; Oladipupo & Okafor, 2005; Dailami & Masson, 2009), while firm better financial performance maximizes shareholders' wealth (Abdullah, 2004;Oladipupo & Okafor, 2005; Azhagaiah, 2008). Thus the appreciation of shares' market price enhance shareholders' confidence by maximizing their wealth (Dailami & Masson, 2009; Benali, 2013; Placido M. Menaje, 2012). Many researchers concluded that there is positive relationship between firm financial performance and share price. The appreciation in share price increase shareholders' confidence (Rafael La Porta et al. 2000; Velnampy, 2013; Dailami & Masson, 2009; Malik, 2012; Kehinde, 2012). On the basis of agency and shareholders primacy theories it is hypothesis that:
*H4 (a): Firms' financial performance is positively correlated to shareholders' confidence before MCCG 2012.*
*H4 (b):Firms' financial performance is positively correlated to shareholders' confidence after MCCG 2012.*

**Scope and Methodology of the Study**
The proposed study based on secondary data to be extracted from annual reports of Malaysian listed companies and DATA STREAM (Noor & Fadzil, 2013; Shukeri et al., 2012) from 2010 to 2013. CG data will be extracted from Annual reports of the companies while data regarding firm financial performance and share price will be collected from DATA STREAM for the proposed period. The paper proposes stratified random sample of 300 listed companies from all sectors of the economy except banks and insurance companies due to their different governance requirements. Bursa Malaysia had 823 listed companies on the main board and 110 companies on ACE (Bursa Malaysia, 31 Dec. 2009; Noor & Fadzil, 2013). The paper proposes ordinary least square (OLS) and partial correlation for proposed analysis.

**Conclusion**
Shareholders' primacy theory posits that the prime concern of corporations is to maximize shareholders' wealth. The Agency theory postulates the same in other way that management as an agent of the shareholders has to protect shareholders' interests by maximizing their wealth. However, management due to opportunistic behavior and access to firms' resources serve their own interests rather shareholders'. Thus, the board has this role to monitor managers. However, this role can be only effectively performed if board is independent. Therefore, an independent board (separate leadership and independent chair) can ensure firms' better financial performance which boost up shareholders' confidence.

The separate leadership structure and independent outside chair of the board among others are considered to strengthen independence of the board. Hence, the MCCG 2012 also addressed these two with anticipation of fortifying independence of the board to improve firms' financial performance and shareholders' confidence. However, these postulations still lack empirical evidence. Therefore, this paper proposes to investigate these anticipations empirically by examining the impact of MCCG 2012 on firms' financial performance and shareholders' confidence in pre and post context of the code for more distinctive results.

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